Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM: :TL-N-8066-98

date: April 6, 2001

to: , Manager, SBSE Division Group
Attn: Revenue Agent

from: Associate Area Counsel
CC:LM:

subject:

U.I.L. No. 162.21-01

This memorandum responds to your March 29, 2001 request for assistance. We have expedited our response to your request as you told us on March 29, 2001 that you need our final advice by April 20, 2001. This memorandum should not be cited as precedent.

ISSUE

Whether there is a reasonable basis for taking the position that Code section 162(f) bars the deduction of the following amounts agreed to pay pursuant to an Order on Consent dated : (1) $ paid to the ; and (2) $ agreed to pay the .

CONCLUSION

Based on the facts as currently developed, we believe that there are significant litigating hazards in taking the position that Code section 162(f) bars the deduction of any of the above amounts. However, if you elect to pursue this issue and take that position, we believe the facts provide a reasonable basis for that action. If you elect to pursue this issue, we recommend that you summons current Regional Director , former attorney , and shareholder before you issue FSAAs or notices of deficiency. Those individuals have already advised you that they will not agree to be interviewed by the Service, so that action is necessary to protect the Service's ability to interview them regarding the negotiation of the Order on Consent. See Mary Kay Ash v. Commissioner, 96 T.C.

459, 468-69 (1991). We recommend that you allow us to review any summons before they are issued.

FACTS

The facts, as we understand them, are as follows:

Since [redacted] had owned and operated a [redacted] fuel distribution terminal in [redacted] is located in the [redacted] in [redacted].

In [redacted], [redacted] began installing a series of groundwater monitoring wells at the terminal to comply with newly enacted [redacted] mandates for groundwater monitoring and protection. On [redacted], during the installation of one of the monitoring wells, [redacted] was found floating on the water table approximately [redacted] feet beneath the terminal. [redacted] reported the contamination, which was determined to consist of both dissolved and free product [redacted], to the U.S. Environmental Protection Agency, the [redacted], the [redacted], the [redacted], and the [redacted].

In response to the discovery, [redacted] immediately began pressure testing its piping to determine the source of the leak. On [redacted], a [redacted]. After finding the leaks, [redacted] repaired and pressure tested all piping before returning the systems to service.

The [redacted] was the government agency that took the lead in responding to the spill. The Commissioner of the [redacted] was: (1) the designated trustee of natural resources pursuant to the Comprehensive Environmental Response, Compensation and Liability Act, as amended, 42 U.S.C. § 9607(f)(2); (2) the designated trustee of natural resources pursuant to the Oil Pollution Act, 1990, 33 U.S.C. § 2706(b); and (3) an "authorized representative of the State" within the meaning of the FWPCA, 33 U.S.C. § 1321(f)(5). He was also the trustee and steward of the natural resources of the

state of [redacted] pursuant to [redacted] of the [redacted]. The U.S. Environmental Agency was not involved in responding to the spill.

The [redacted] viewed its role as protecting the interests of all affected parties including the local community and the [redacted] governmental authorities such as the [redacted]. The [redacted] worked with [redacted], the local community, and [redacted] governmental authorities to agree on a long-term approach to the pollution.

The first year following the spill was consumed by immediate response activities. [redacted] began performing interim remediation measures under the direction of the [redacted]. The [redacted] oversaw the drilling of monitoring wells at the site and set up a trailer near the site to coordinate efforts and answer questions from citizens in the community.

On [redacted], the day after the contamination was discovered, [redacted] retained [redacted] to conduct a hydrogeologic investigation to determine the extent of the groundwater contamination and to design remedial facilities. On [redacted], [redacted] began installing groundwater monitoring wells. Initial recovery efforts began on [redacted] with [redacted] monitoring wells. The recovery network gradually expanded to [redacted] wells by [redacted].

During [redacted], [redacted] began installing vapor monitoring wells to monitor potential vapor impact to the homes bordering the free product plume. Delineation of the free product plume was completed during [redacted]. The contamination was estimated to cover about [redacted] acres.

According to an [redacted] report dated [redacted], as of [redacted], the following major tasks had been completed:

- the site had been characterized geologically and hydrogeographically;
- the areal extent of the free product had been determined and the volume of the mobile free product had been estimated;
- the potential for hydrocarbon vapor impact on nearby homes had been investigated;
- free product recovery operations had begun and [redacted] gallons had been recovered through [redacted];

- the potential impact of the leak on wellfields during peak summer pumpage conditions had been analyzed; and

- delineation of the dissolved product plumes had progressed substantially.

The initial effort was followed by a period of working with the data generated by the monitoring wells to project where the pollution plume was likely to move and what impact various alternative remediation approaches would have on it. During that period continued to perform short-term remediation work under the direction of the .

On , the commissioner wrote to . The letter commended for its part in what the letter described as remarkable and encouraging response to the contamination, but stated that had missed its deadline for submitting final remedial plans. The letter encouraged to adhere to the schedules it had agreed to meet.

During , proposed a plan to remediate the contamination caused by the spill, and the approved the remedial plan on . The plan's approach to the contamination was for to remedy the contamination by pumping contaminated water out of the ground and treating it to remove the contamination. A key feature of the plan was for to construct and operate a gallons per day ("gpd") groundwater extraction and treatment facility. According to , all design work for the mgd system was completed by and all applications for permits necessary for the system were submitted to the on .

On , proposed to the an alternative to the construction and operation of the gpd groundwater treatment facility. The proposal took the position that more pollutants would be introduced into the environment by operating the facility than the facility would remove from the ground water. The proposal said that the groundwater model developed by predicted that the contamination posed no health risk because it would never reach public supply wells, that no environmental harm would result from the natural flow of progressively less contaminated ground water toward its ultimate discharge as clean water into the and that the vapor extraction system then in operation had stabilized

the [redacted] plume and would consistently reduce the rate of contaminant transfer into the groundwater system. The proposal concluded that:

> the construction and operation of the water treatment system would amount to an expenditure of many millions of dollars for an indefinite period to treat groundwater that well never be used for public consumption (and which if left alone will clean itself up via biodegradation) and at a net cost to the environment that far exceeds any benefit from such treatment. Moreover, the ground water intended to be so treated contains only 5% or less of the contaminants present in the subsurface environment as a result of the [redacted] leak.

As an alternative to constructing and operating the groundwater treatment system, [redacted] proposed:

1. To continue to operate and expand the vapor extraction system then existing and operating to the west of the terminal;

2. To redirect $[redacted], representing the estimated capital cost of the treatment system, toward the acquisition of [redacted] land located within the [redacted], thereby preserving pristine land updradient of the terminal and protecting it from future development and degradation of its ground water;

3. The protection of ground water supplies at [redacted] and [redacted] well fields by the assurance that, in the event of contamination, [redacted] will pay for wellhead treatment, deepening of wells, or relocation of the well fields. [redacted]'s assurances in this regard would be backed up by the creation of an escrow fund under the control of the [redacted] to which [redacted] will contribute $[redacted] a year for [redacted]; and

4. All private wells downgradient from the leak area and within [redacted] mile on either side of the projected ground water flow path would be connected to the public water supply mains at [redacted]'s expense.

According to [redacted], it withdrew its applications for permits to operate the [redacted] mgd treatment facility with [redacted]'s concurrence on [redacted].

On [redacted], [redacted] wrote to the [redacted] and proposed developing a remediation plan to replace the plan that the [redacted] had approved on [redacted]. [redacted]'s letter explained as follows:

> During the course of implementing the current Remediation Plan, [redacted] ([redacted]'s consultants) has constructed groundwater flow and solute transport models of the site and vicinity. [redacted] has also evaluated the risks to public health presented by the contamination at the site. The findings of these efforts and the successful operation of the large scale vapor extraction and treatment facility (VETF) suggest that a different remedial approach may be more appropriate and better for this site than past plans.

Enclosed with the letter was a document entitled "Technical Remediation Proposal." The proposal called for several studies to be performed and for the results of those studies to used as "the basis for the definition of additional remedial measures to be implemented, if any." The proposal suggested that, based on the effectiveness of the vapor extraction technique, future remedial activities concentrate on the extension, optimization, and enhancement of the VETF rather than on the pump and treat approach of the plan that the [redacted] had approved on [redacted]. The specific steps recommended by the proposal are as follows:

a. Continue the operation of the interim remediation measure system then in place to control the free product plume until the threat of further movement is eliminated;

b. Perform a study to determine the effectiveness and practicality of a limited pump and treat system designed to restrict the flow of contaminants to the [redacted] and shallow [redacted] aquifers;

c. Establish appropriate additional outpost monitoring wells to assure early warning of any contaminant flow toward the well screens of the [redacted] and [redacted] Wellfields;

d. Connect private well users to public water supplies;

e. Provide financial assurances to [redacted] for costs of wellhead treatment or well relocation as part of contingency plan to assure continued supply of uncontaminated water;

f. Monitor contaminant plumes not being actively remediated to determine if natural attenuating processes are taking place and if the plumes are taking the courses predicted. If not and they pose a threat to geographic areas not addressed in this proposal, [redacted] will protect the new areas in a manner consistent with this proposal; and

g. Establish objective criteria by which determination can be made for the termination of each remedial activity and the return of affected property to productive use.

The [redacted] granted [redacted]'s request set forth in its [redacted] letter subject to three conditions. First, [redacted] was required to submit a report presenting the results of the its studies and a detailed, comprehensive alternative remedial plan by [redacted]. Second, [redacted] was to continue all existing and ongoing remedial activities as it conducted the studies. Third, [redacted] was required to accelerate the portion of its studies that focused on the adequacy of the [redacted] wellfield outpost well monitoring network and, should a need arise for additional or relocated outpost wells, they should be installed as soon as appropriate locations are identified. The [redacted]'s approval letter stressed that unless an alternative remedial plan was approved by the [redacted], [redacted] was required to continue to implement the existing remedial plan as per the plan approved by the [redacted] on [redacted].

On [redacted], [redacted] provided the [redacted] with a [redacted] report entitled "Evaluation of Groundwater Plume Management Altermatives." The report presented the results of the groundwater modeling study defined in [redacted]'s [redacted] Technical Remediation Proposal. It evaluated the cost and benefits of using groundwater pump and treat technology to reduce the migration of contaminated groundwater.

The [redacted] responded to the report on [redacted]. The response asked [redacted] to modify the report. [redacted] responded to the [redacted]'s comments on [redacted].

The [redacted] and [redacted] continued to discuss the remediation of the contamination during [redacted] and early [redacted]. At some point, a draft Order on Consent was exchanged between the two parties. On [redacted], [redacted] provided the [redacted] with plans and specifications for a [redacted] gallon per day groundwater extraction and treatment facility. The transmittal letter stated that the plans were being submitted pursuant to the requirements of the remediation plan

contained in the proposed order on consent even though the order had not yet been executed.

The [redacted]

The [redacted] supplies the public with water drawn from wells. After being notified of the groundwater contamination, the [redacted] engaged the professional groundwater consulting firm [redacted] to evaluate whether any of its well fields in the vicinity of the site were threatened by groundwater contamination. One of the well fields, the [redacted] Well Field, was located [redacted]. On [redacted], those consultants reported to the [redacted] that:

> Data generated to date indicate that none of the well fields in proximity to this site are imminently threatened by ground-water contamination resulting from the [redacted] spill. Further work will be needed to adequately define the extent of the dissolved [redacted] plume and to effect remediation which will fully protect the well fields. However, water-quality monitoring can be reduced in all fields, with the exception of [redacted], to a monthly basis.
>
> Because of ongoing work to define the extent of the problem associated with a separate source of contamination on the eastern part of the terminal, we recommend [redacted] testing be maintained on a weekly basis until the outpost wells are completed and tested. * * *

On [redacted], the consultants faxed the [redacted] a document entitled "Contingency Plan for the [redacted] Well Field." The document stated that the contamination had not adversely impacted the quality of water withdrawn from well fields used for public water supply and that based on the results of extensive tests, it was "very unlikely that the water soluble contamination * * * will impact the integrity of the [redacted] Well Field." The report concluded that "[i]n the unlikely event" that elevated levels of contaminants reached the well field, the contamination could be easily removed from the water by constructing carbon filters at the well head to treat the water.

The conclusion that it was very unlikely that contamination would reach the [redacted] Well Field was based on [redacted]'s estimate that the field had a capture radius of between [redacted] feet at average pumping conditions ([redacted] gallons per minute ("gpm")).

Internal notes that appear to have been prepared by [redacted] personnel state that assuming an average pumpage of [redacted] gpm was unrealistic. The notes state that the field is capable of [redacted] gpm and that assuming a lower rate would prevent the field from being operated at full capacity.

During [redacted], a site specific groundwater model was developed to predict whether the contamination would impact public water supply wells in the vicinity of the terminal. [redacted], which by then had replaced [redacted] as [redacted]'s environmental consultants, periodically compared the contamination predicted by the model to contamination measured in the field. [redacted] then periodically updated the model to make the results predicted by the model more consistent with what had actually occurred.

On [redacted], the [redacted] responded to a report evaluating the risk to groundwater posed by the contamination. The [redacted] opined that the report oversimplified the risks to groundwater posed by the spill by failing to determine whether existing will fields would be sufficient to meet the long-term needs of the community, by assuming that pumping rates would remain stable (rather than increase to meet increased future demands), and by presuming that all existing and future private well sites would be served by public water supply.

As of [redacted], [redacted] concluded that the model predicted that contaminant concentrations at the [redacted] well field would not exceed [redacted] standards. [redacted] also concluded that the model's prediction of the plume's movement in the direction of the [redacted] well field was supported by field observations.

Reports prepared after the [redacted] had settled its claims against [redacted] continued to predict that the [redacted] and [redacted] wellfields would not be impacted by the contamination. As of [redacted], [redacted] concluded that the model had been used to successfully predict the plume's movement in the direction of the [redacted] well field. An [redacted] report concluded that:

> Groundwater modeling updates and refinements have improved the ability of the model to reproduce data recently collected, but have not changed the results of the risk assessment findings or of the final remediation plans.

[redacted]

( ) indicate that the and well fields, respectively, are simulated not to be impacted in the future by contamination from the terminal.

The Settlement of 's Liability Relating to the Spill

The process begun when the spill was reported in culminated on with the signing of three agreements:

(1) an Order on Consent between the and ;

(2) 's execution of a settlement agreement between and the which had been signed by the on ; and

(3) a settlement agreement by and among: (a) and each of its agencies, departments, governmental entities, and authorities; (b) the ; and (c) .

Those agreements settled 's liability to the entities involved. In addition, the agreements released the , the , and State from all claims , the , and the might have against them as a result of the spill.[1]

The considers the process by which the parties agreed on a long-term approach to the contamination to have been very quick given the magnitude of the spill. The credits the speed within

[1] By letter dated , the notified that the had filed an application for damage compensation with the . The letter stated that the Fund Administrator would attempt to promote a settlement between the two parties if it determined that was responsible for the discharge, and that if a settlement could not be achieved, the Administrator would pay the what either it or an arbitrator determined was the proper amount and then seek to recover that amount from .

which the parties were able to agree on a long-term approach to the contamination to [redacted]'s good cooperation.

The Order on Consent

Under the Order on Consent, [redacted] was required to: (1) carry out a detailed plan designed to remediate the contamination; (2) pay the [redacted] $[redacted] for [redacted]; and (3) execute settlement agreements with [redacted] and the [redacted], and with the [redacted].

According to the Order on Consent, [redacted] had performed studies, submitted data, and conferred with the [redacted] regarding a remediation strategy and program for the spill. The Order on Consent recites that remedial actions taken by [redacted] had included the recovery of over [redacted] gallons of [redacted] and [redacted] pounds of [redacted] vapor; the installation and monitoring of over [redacted] groundwater monitoring wells and [redacted] vapor monitoring wells; the construction and operation of a [redacted] gallon a minute groundwater extraction and treatment facility; and the construction and operation of a [redacted] cubic feet a minute vapor extraction and treatment system.

The Order on Consent recites that [redacted] was potentially liable under [redacted] law for both the costs of cleaning up the spill and penalties for allowing the spill to occur and continue. Paragraph [redacted] of the Order on Consent recites that [redacted] "[redacted]." Paragraph [redacted] of the Order on Consent recites that the [redacted] had alleged that [redacted] had violated [redacted] (prohibiting the discharge of [redacted]), [redacted] (requiring the immediate containment of [redacted] discharges), and [redacted] (generally prohibiting water pollution). Paragraph [redacted] of the Order on Consent recites that [redacted] law provides "a penalty" for violating each of those provisions, referring to [redacted] (providing "a penalty" of up to $[redacted] a day for violations of [redacted]; [redacted] (providing "a penalty" of up to $[redacted] a day for violating [redacted]; and [redacted] (providing "a penalty" of $[redacted] initially and $[redacted] a day thereafter for releasing [redacted]).

The Order on Consent settled [redacted]'s potential liability under [redacted] law for both the cost of cleaning up the spill and the penalties for allowing the spill to occur. Paragraph I of the Order on Consent recites that:

[redacted]

It continues that:

[redacted]

The execution of the Order on Consent brought closure to the spill issue from both [redacted]'s and the [redacted]'s perspectives. From the [redacted]'s perspective, the Order on Consent moved its work on the spill from the design stage to the completion stage. The execution of the Order on Consent enabled the [redacted] to redirect significant resources from the spill to other matters. The Order on Consent unburdened the technical, legal, and management personnel that the [redacted] had assigned to addressing the spill and allowed it to reassigned responsibility for the spill to a single employee who would monitor [redacted]'s compliance with the agreement. From [redacted]'s perspective, the execution of the Order on Consent defined its remediation obligations and prevented the State from later imposing more onerous obligations.

The Remediation Plan

The detailed remediation plan contained in the Order on Consent required [redacted] to perform various remediation activities, including constucting a [redacted] gallons per day groundwater treatment facility. The plan was what the [redacted]

considered the optimum remediation plan. In the 's view, requiring to perform any more remediation work than was provided for in the Order on Consent would have been impractical, if not wasteful, as additional work would have produced no environmental gain. The did not reduce the remediation work that it required to perform in exchange for the payments was required to make to the or to the pursuant to the Order on Consent.

The $ Agreed to Pay the

a. How the Amount was Arrived At

Little is currently known about how the $ amount of damages that agreed to pay the under the Order on Consent was negotiated. stated in an IDR response that it offered the amount based on what it would have cost it to construct and operate the mgd pump and treat plant called for under the remediation plan that the had approved on , but has declined to produce any witnesses to explain that response. The personnel who were involved in negotiating the Order on Consent with have declined to discuss the matter with the Service, citing a policy that settlement negotiations be kept confidential. It is known that before it agreed to the $ of , the Commissioner of the asked a newly hired economist in the 's , to evaluate whether $ was an adequate amount of compensation for . received the request on , the day she started work for the . estimated the amount of caused by the spill as between $ and and $ and opined that the $ was a good offer. According to the Administrator of Region at the time the Order on Consent was negotiated, the had decided not to fine because it reported the spill and was so cooperative during the process of reaching a final resolution of the matter. Although he would not comment about this specific case, , the 's current Director of Enforcement, stated that the bases its decisions whether to penalize polluters on the case as a whole rather than on whether a polluter agrees to pay a greater amount of .

b. The Memorandum of Agreement

The $ that agreed to pay the Commissioner of the was discussed in a separate memorandum of agreement

entered into between the [redacted] and [redacted] on [redacted]. That memorandum of agreement recited that the Commissioner of the [redacted] had recovered $[redacted] of [redacted] as trustee on behalf of the people of [redacted] for "injuries to, the loss of, and destruction of [redacted]'s [redacted] resulting from [the spill]" and that the [redacted] would use the money to develop and implement a Restoration and Replacement Plan. In the memorandum of agreement, the [redacted] agreed to develop a plan on how to spend the $[redacted] and to consult with [redacted] in connection with the development of the plan. The memorandum of agreement stated that:

[redacted]

c. The Resource Restoration and Replacement Plan

Pursuant to the memorandum of agreement, the [redacted] issued a draft Resource Restoration and Replacement Plan on [redacted]. [redacted], the commissioner of the [redacted], approved the final version of the draft after it was modified as a result of comments received during a public comment period that extended through [redacted].

The approved Resource Restoration and Replacement Plan provided that the [redacted] would use the $[redacted] as follows:

(1) $[redacted] would be expended in the [redacted] which is located within the [redacted] in the [redacted], substantially contiguous to the spill site. Of that amount, $[redacted] was earmarked to acquire land to complete a greenbelt, and $[redacted] was earmarked to connect an industrial park adjacent to the greenbelt to sanitary sewers. The Resource Restoration and Replacement Plan states that this effort "represents an important

opportunity to assemble a contiguous tract of land suitable as an area, and simultaneously desirable as a which is in the immediate vicinity of the community affected by the impacts of the [spill]."

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(2) $ would be expended to acquire privately held parcels in the , which is located within the . The Resource Restoration and Replacement Plan explained that:

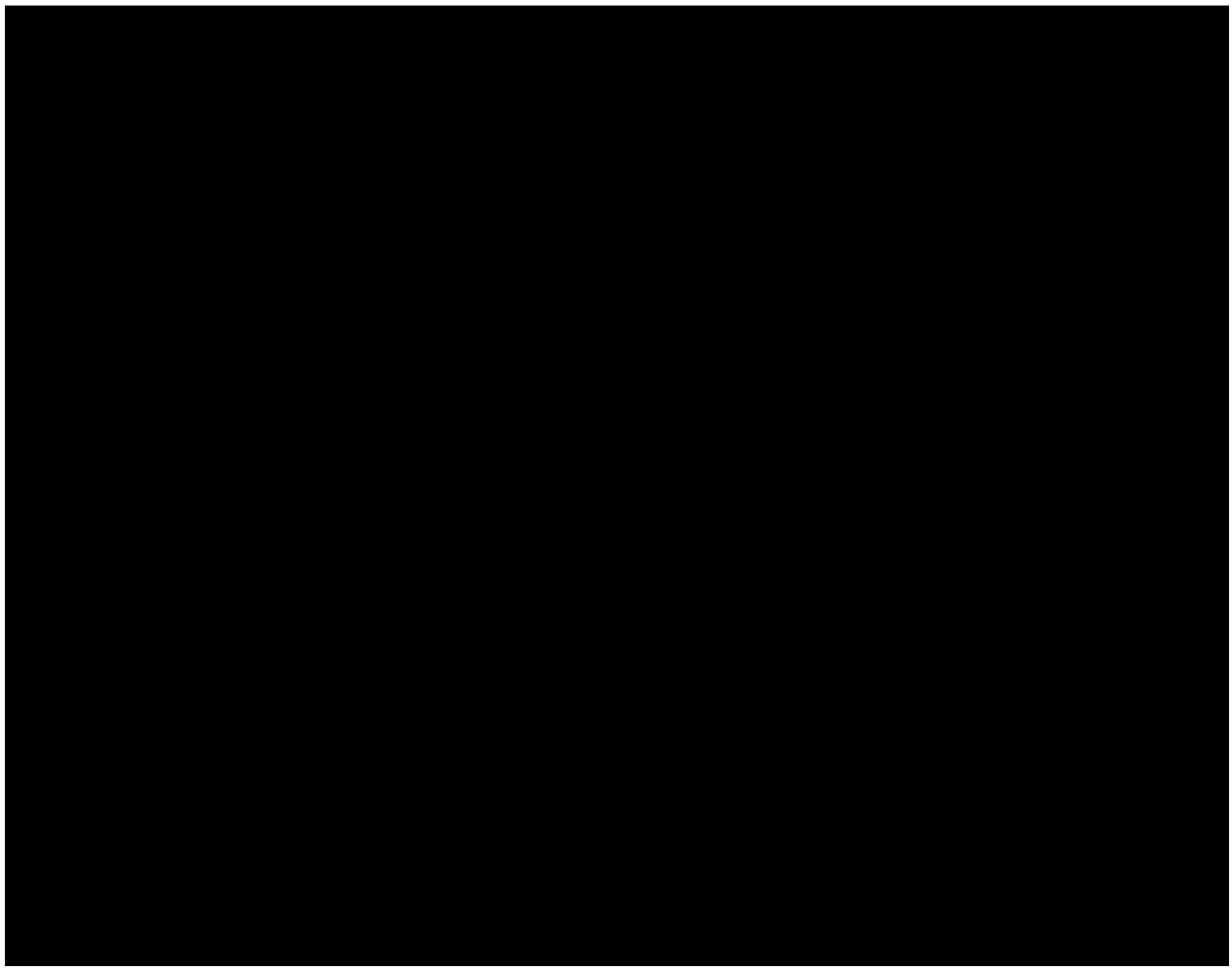
.

It is also noted that the is situated in the , established in , Article . The) stresses the opportunity which exists to protect this valuable source of recharge through additional public land acquisitions.

Thus, acquisition of parcels in the of the is consistent with land acquisition and groundwater recharge area protection initiatives of local, County and State government. Such acquisition would score favorably under the Plan, and has been given the highest priority under the s .

Moreover, such acquisitions clearly would preserve important recharge areas for s system, an important consideration given the nature of the natural resource damage being mitigated.

(3) $ would be used for up to years as seed money to create a core area. The Resource Restoration and Replacement Plan explained this program as follows:



Agreements with , , and ,

As required by the Order on Consent, entered into a settlement agreement with the and a separate settlement agreement with and the , . An draft version of the agreement had been circulated to th , on .

, 's agreement with the , required to pre-fund the cost to be paid by the

authority to extend public water mains to the certain locations in [redacted] and obligated the water authority to account for and return to [redacted] any unused funds. In addition, the agreement required [redacted] to pay the water authority $[redacted] a year for [redacted] years. The agreement recited that the $[redacted] was:

> to be expended as the [redacted] deems appropriate for the purposes of monitoring the groundwater at the [redacted] and [redacted] Wellfields located in the [redacted] (the "Wellfields") and for implementing measures to remediate groundwater contamination at the Wellfields, if any, including but not limited to wellhead treatment, deepening of the wells and relocation of the wells.

According to [redacted], the Chairman of the [redacted], a representative of [redacted] offered the authority the $[redacted] if the authority would execute the settlement agreement with [redacted]. After reviewing the figure, the [redacted] determined to accept the offer. According to [redacted] of the [redacted], the [redacted] assured the [redacted] that $[redacted] was enough to enable it to treat public drinking water if, in a worst case scenario, the spill [redacted].

ANALYSIS

This matter has been the subject of factual development over an extended period. We have addressed the applicability of Code section 162(f) to the amounts at issue, and provided advice on the development of the issue, in a number of previous memoranda. Those memoranda include memoranda dated January 21, 1999, February 5, 1999, June 8, 1999, and November 7, 2000. The advice contained in each of those memoranda was based on our understanding of the facts as they had then been developed as of those respective dates. In our most recent memorandum addressing the issue, we concluded on November 7, 2000 that the facts did not provide a reasonable basis for taking the position that Code section 162(f) bars the deduction of the amounts at issue.

The conclusion in our November 7, 2000 memorandum that there is not a reasonable basis for taking the position that Code section 162(f) bars the deduction of the amounts was based upon our understanding of the facts that had then been developed as of that date. However, since then, additional facts have been developed and brought to our attention. Specifically:

- We learned from documents that you provided us on February 16, 2001 that models used to predict the migration of the pollution plume predicted that it was unlikely that the plume would contaminate [redacted] well fields.

- We learned from a [redacted] interview with [redacted] of the [redacted] that the $[redacted] [redacted] agreed to pay the [redacted] was not in lieu of remediation work that [redacted] would have otherwise been required to perform. [redacted], who was the [redacted] official with hands on responsibility for developing the remediation plan that the Order on Consent required [redacted] to perform, stated that the remediation plan was what the [redacted] considered was the optimum remediation plan. He stated that requiring [redacted] to perform any more remediation work than was provided for in the Order on Consent would have been impractical, if not wasteful, as additional work would have produced no environmental gain. He stated that the [redacted] did not reduce the remediation work that it required [redacted] to perform in exchange for [redacted]'s agreement to pay the amounts at issue. [redacted] said that although he does not recall discussing penalties, he was not involved in the negotiation of the amounts at issue. He explained that his job was limited to developing the remediation plan. He identified current [redacted] Regional Director [redacted] and former [redacted] attorney [redacted] as individuals who would have knowledge of the negotiation of the amounts. Regarding the $[redacted] that [redacted] agreed to pay the [redacted] stated that the amount was what the [redacted] had told him would be enough to enable that authority to deal with the contamination in the worst case event that it reached public well fields.

- We learned from a [redacted] interview with personnel from the [redacted]'s [redacted] that it is impossible to determine from the Order on Consent whether the amounts were paid as compensatory natural resource damages or to fund an environmental benefit project in lieu of a penalty. During that interview, Senior Economist [redacted] explained that companies threatened with penalties sometimes agree to fund projects to benefit the environment rather than paying penalties. During the interview, [redacted] attorney [redacted] and [redacted] supervisor [redacted] reviewed the Order on Consent and informed us that it was impossible to determine from the order whether the amounts at issue were paid as compensatory natural resource damages or to fund an environmental benefit project in lieu of a penalty.

[redacted] opined that the Order on Consent was an unusual order in that respect. [redacted] and [redacted] and [redacted] advised that the Service should interview the personnel who negotiated this aspect of the settlement if we need to determine whether the amounts at issue were paid to fund an environmental benefit project in lieu of a fine or penalty. They identified current [redacted] Regional Director [redacted] and former [redacted] attorney [redacted] as individuals who would have knowledge of that matter.

Based on the results of the interviews with [redacted] and the [redacted] personnel, you attempted to interview current [redacted] Regional Director [redacted], former [redacted] attorney [redacted], and [redacted] shareholder [redacted] regarding the negotiations that took place between [redacted] and the [redacted] over the amounts at issue. All of those individuals declined to be interviewed. [redacted] declined your request to interview [redacted] citing advice of counsel. [redacted] and [redacted] declined to be interviewed citing the [redacted]'s policy that such negotiations remain confidential.

Based on the above facts that have been developed and brought to our attention since November 7, 2000, and the facts that were then known, we believe there is a reasonable basis for taking the position that Code section 162(f) bars the deduction of the amounts at issue. Our rationale is explained below:

The Order on Consent recites that the [redacted] had asserted that [redacted] was liable for cleanup costs and that the [redacted] had asserted that [redacted] had violated [redacted] laws for which there are substantial penalties. [redacted]'s agreement to the Order on Consent constituted a full settlement of "any and all claims" that the [redacted] had or might have been asserted against [redacted] including penalties. Given that [redacted]'s obligation to pay cleanup costs was satisfied by [redacted]'s agreement to complete the remedial plan required under the Order on Consent, it appears that the $[redacted] at issue must be considered either an amount paid in settlement of [redacted]'s actual or potential liability for a fine or penalty (in which case the amount would be nondeductible pursuant to Code section 162(f) and Treas. Reg. § 1.162-21(b)(1)(iii)) or compensatory damages (in which case the amount would be deductible pursuant to Treas. Reg. § 1.162-21(b)(2)).

We believe that [redacted] has failed to establish that the amount was not paid in settlement of its actual or potential liability for a fine or penalty. [redacted] had stated during an

interview that the decided not to fine because it reported the spill and was so cooperative during the process of reaching a final resolution of the matter, but did not explain whether the cooperation he described included 's agreement to pay the amounts at issue. We believe that the fact that the Order on Consent absolves from liability for fines and penalties suggests that 's agreement to pay the amount at issue was at least partially motivated by a desire to settle its potential liability for fines and penalties. Moreover, if the 's decision not to fine was based in part on 's agreement to pay the amounts at issue, or put another way if the might have sought to fine if had refused to pay the amounts at issue, then we believe the $ would arguably constitute a nondeductible amount paid in settlement of 's actual or potential liability for a fine or penalty.[2] Unfortunately, 's refusal to cooperate with your request to interview , and the 's assertion that the details of its negotiations with are confidential, have prevented you from interviewing the individuals with knowledge of the negotiations between those parties.

Although argues that the $ at issue must be considered compensatory, we believe that two facts undermine that argument. First, the results of the model used to predict the migration of the contamination plume predicted that it was unlikely to contaminate the public water supply wells used by the . Thus, the had never suffered, and it appears was unlikely to ever suffer, damages to be compensated for by the $ that agreed to pay it. Second, the $ that agreed to pay the was to be used to purchase land that had not been polluted by (most of which was located outside of the groundwater protection area in which the pollution had occurred),

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[2] We note that it has been suggested that the lacked the ability to fine and that the $ agreed to pay the accordingly could not have been paid in settlement of a potential fine or penalty. We disagree. Even if the lacked the ability to fine , the fact remains that the required to agree to pay that amount as part of the overall settlement with . The had the ability to fine . We accordingly believe that the amount might be viewed as having been paid in settlement of a potential fine even if the lacked the ability to fine .

and to fund a transfer of development rights bank outside of the area in which the pollution had occurred. There has been no showing that the $[redacted] was to be used to compensate the specific victims of [redacted]'s pollution for the specific losses they suffered. Instead, it appears that the $[redacted] was to be used by [redacted] State for the general public good. See Allied-Signal, Inc. v. Commissioner, 95-1 U.S.T.C. ¶ 50,151 (3d Cir. 1995), aff'g, T.C. Memo. 1992-204.

We view the facts of this case as analogous to the situation presented in Allied-Signal. In that case, a taxpayer who had released Kepone, a toxic chemical, into the environment spent approximately $800,000 to decontaminate the site and nearby materials and waste water, and conducted intensive research on methods of identifying and retrieving Kepone from the environment. In addition, the taxpayer contributed $8 million to an endowment created to "alleviate the effects of Kepone on the environment and on the lives of the affected persons and generally to improve and enhance the quality of the environment in [the state in which the chemical had been released]." 95-1 U.S.T.C. at 87,540. The taxpayer argued that the $8 million should be considered compensatory damages because it was designed to ameliorate the harm caused by the pollution. The U.S. Court of Appeals for the Third Circuit rejected that argument. It reasoned that the endowment served general public purposes rather than compensating the aggrieved parties for the specific losses attributable to the taxpayer's misconduct. It concluded that "[t]o hold that punitive exactions used for general public purposes fall outside the ambit of section 162(f) would effectively nullify the statute, since all exactions of this nature are ultimately used for general public purposes." Id. at 87,543. That rationale appears to be equally applicable in this case. Although the $[redacted] may have been intended to be put to use for a commendable purpose, that commendable purpose was arguably a general public purpose rather than a specific purpose of compensating for the specific damage caused by [redacted]'s spill. As a result, it appears that as was the case with the $8 million involved in Allied-Signal, the $[redacted] that [redacted] agreed to pay the [redacted] cannot be considered compensatory damages.

This opinion is based on the facts set forth herein. It might change if the facts are determined to be incorrect or if additional facts are developed. If the facts are determined to be incorrect or if additional facts are developed, this opinion should not be relied upon. You should be aware that, under routine procedures that have been established for opinions of this type, we have referred this memorandum to the Office of Chief Counsel for review.

That review might result in modifications to the conclusions herein. We will inform you of the result of the review as soon as we hear from that office. In the meantime, the conclusions reached in this opinion should be considered to be only preliminary. If we can be of further assistance, you may call the undersigned at [redacted].

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse affect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

[redacted]
Area Counsel [redacted]

By: _____
[redacted]
Senior Attorney